ANNEX

IMF EXECUTIVE BOARD DISCUSSION OF THE OUTLOOK, MARCH 2012

The following remarks by the Acting Chair were made at the conclusion of the Executive Board's discussion of the World Economic Outlook *on March 30, 2012*

Executive Directors noted that global prospects are gradually strengthening again, but the recovery remains tenuous and risks are firmly to the downside. Improved activity in the United States and policies in the euro area have reduced the threat of a sharp global slowdown. However, the recent improvements are very fragile, and many sovereigns and banks remain under substantial pressure. The present calm offers a golden opportunity for policymakers to finally get ahead of the crisis. Policymakers must continue implementing the fundamental changes required to achieve lasting stability, which is a prerequisite for healthy growth over the medium term. With output gaps remaining large in advanced economies, policies must also be calibrated with a view to supporting still-weak growth in the near term.

Directors agreed that a weak recovery will likely resume in the major advanced economies, and activity is expected to remain relatively solid in most emerging and developing economies. Nevertheless, growth projections for most regions have been revised down relative to the September 2011 *World Economic Outlook,* mainly on account of the damage done by deteriorating sovereign and banking sector developments in the euro area. The euro area is still projected to go into a mild recession in 2012. Job creation in advanced economies will likely remain sluggish. Growth in emerging and developing economies is also projected to slow in 2012 but is expected to reaccelerate in 2013, helped by easier macroeconomic policies and strengthening foreign demand.

Directors noted that recent policy steps have been crucial in stabilizing euro area financial markets. They cautioned, however, that sovereign risks are still elevated and that pressures on European banks remain, including from sovereign risk, weak euro area growth, high rollover requirements, and the need to strengthen capital cushions. Together, these pressures have induced a broader drive to reduce balance sheet size. While much of the deleveraging to be undertaken by euro area banks will likely be in the form of capital generation or the sale of securities and other noncore assets, some of it will likely lead to a reduced supply of credit to the real economy. Directors agreed that, while further shrinkage of European banks' balance sheets is healthy, the potentially negative consequences of a synchronized large-scale deleveraging remain a concern.

Directors generally agreed that the most immediate concern is that a reintensification of the euro area crisis will trigger a more generalized flight from risk and disorderly deleveraging by European banks. They noted IMF staff stimulations indicating that the recurrence of funding pressures comparable to those seen in fall 2011 could have substantial repercussions for the credit supply in the euro area and beyond.

Directors stressed that other downside risks continue to loom large. Geopolitical uncertainty could trigger a sharp increase in oil prices. Excessively tight macroeconomic policies could also push another major economy into sustained deflation. Additional risks include disruption in global bond and currency markets, with sudden increases in interest rates as a result of high budget deficits and debt, and rapidly slowing activity in some emerging market economies. However, growth could also be better than projected if policies improve further, financial conditions continue to ease, and geopolitical tensions recede.

Directors concurred that policymakers in Europe should build on recent progress and market improvements to push ahead with the implementation of agreed-on reforms and complete the policy agenda. The key priority over the near term is to build a sufficient, robust, and credible firewall in Europe to deter contagion. Further progress on bank restructuring and resolution should complement the increases in bank capital and provisioning already under way. Just as important are far-reaching institutional reforms that remedy design flaws in the economic and monetary union that contributed to the crisis, including policies for further integration that reinforce financial stability. Turning to macroeconomic policies, sufficient fiscal consolidation is taking place, and the pace of near-term fiscal adjustment plans should be calibrated to avoid undue pressure on demand in the near term, without undermining fiscal sustainability. With fiscal multipliers likely on the high side in the weak current environment, a gradual but steady pace of adjustment is preferable to heavy front-loading, as long as financing allows. Given prospects for very low domestic inflation, policy rates should be cut where feasible and unconventional support should be maintained or expanded further when some markets are under acute pressure.

Directors observed that in the United States and Japan there is still an urgent need for strong, sustainable fiscal consolidation paths over the medium term. Also, further monetary easing may be needed in Japan to ensure that it achieves its inflation objective over the medium term. More easing would also be needed in the United States if activity threatens to disappoint. More generally, given the weak growth prospects in the major economies, countries with room for fiscal policy maneuvering can reconsider the pace of consolidation. Others should let automatic stabilizers operate freely for as long as they can readily finance higher deficits. However, putting public finances on a sounder footing over the medium term remains a key requirement for sustainable growth. The environment of high uncertainty also puts a premium on broad and proactive communication strategies to bolster confidence and credibility.

Directors emphasized that beyond the short term, the challenge for advanced economies is to improve the weak medium-term growth outlook. Financial sector reform must address many weaknesses brought to light by the financial crisis, including problems related to institutions considered too big or too complex to fail, the shadow banking system, and cross-border collaboration between bank supervisors. Progress in the design and implementation of credible medium-term adjustment plans is accelerating, but there is still a long way to go, including in the largest economies. The reform of entitlement programs, together with renewed efforts to strengthen fiscal frameworks, is crucial as a way to greatly reduce future spending without significantly harming demand today and can help rebuild market confidence in the sustainability of public finances. Growth-enhancing structural reforms must also be deployed on many fronts.

Directors noted that the key near-term challenge for emerging and developing economies is to appropriately calibrate macroeconomic policies to address the significant downside risks from advanced economies while keeping in check overheating pressures from strong activity, high credit growth, and renewed risks from energy prices. The appropriate response will vary. For economies that have largely normalized macroeconomic policies, the near-term focus should be on responding to adverse spillovers and lower external demand from advanced economies and dealing with volatile capital flows. Other economies should continue to rebuild macroeconomic policy room, which eroded during 2008–09, and strengthen prudential policies and frameworks. The slower pace of fiscal adjustment envisaged in 2012 in emerging market economies is appropriate in the context of weaker growth and given their relatively strong fiscal positions. Monetary policymakers need to be vigilant that oil price hikes do not translate into broader inflation pressures, and fiscal policy must contain damage to public sector balance sheets by targeting subsidies only to the most vulnerable households.

Directors agreed that the latest developments suggest that global current account imbalances are no longer expected to widen, following their sharp reduction during the Great Recession. This is

largely because the excessive consumption growth that characterized economies that ran large external deficits prior to the crisis has been wrung out and has not been offset by stronger consumption in surplus economies. Accordingly, the global economy has experienced a loss of demand and growth in all regions relative to the boom years just before the crisis. Rebalancing activity in key surplus economies toward higher consumption, supported by more market-determined exchange rates, would help strengthen their prospects as well as those of the rest of the world.

Directors underscored that austerity alone cannot treat the economic malaise in the major advanced economies. Policies must also ease the adjustments and better target the fundamental problems—weak households in the United States and weak sovereigns in the euro area—by drawing on resources from stronger peers. Policymakers must guard against overplaying the risks related to unconventional monetary support and thereby limiting central banks' room for policy maneuvering. While unconventional policies cannot substitute for fundamental reform, they can limit the risk of another major economy falling into a debt-deflation trap, which could seriously hurt prospects for better policies and higher global growth.